

Appeal from a decision of the Director, Minerals Management Service, affirming an order regarding the manner of calculating an approved transportation allowance for royalty oil. MMS-86-0200-OCS.

Set aside and remanded.

1. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

The inclusion in a transportation allowance for royalty oil of a return on capital assets based on the prime rate of interest may be sustained as reasonable, but where the date on which the prime rate is determined is inconsistent with prior applications of the rate upheld as reasonable, the case will be remanded to resolve the inconsistency.

APPEARANCES: Charles L. Katz, Esq., Houston, Texas, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard Chalker, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

Exxon Company, U.S.A. (Exxon), has appealed a March 11, 1988, decision of the Director, Minerals Management Service (MMS), denying an appeal of a decision by the Royalty Valuation and Standards Division (RVSD), Royalty Management Program. The RVSD decision, pertaining to offshore oil production from the Santa Ynez unit, 1/ ordered Exxon to retroactively adjust its transportation allowance for the period January 1, 1984, through April 30, 1985, by substituting actual transportation costs for hypothetical transportation costs. Exxon's appeal is limited to the proper rate of return on capital investment to be used in calculating the transportation allowance.

Prior to 1984, substantially all the production from the Santa Ynez unit was shipped to Baytown, Texas. For royalty purposes, value was computed by deducting the hypothetical costs of transportation from the offshore production platform to Los Angeles from the value of the production

1/ The Santa Ynez unit includes Outer Continental Shelf leases numbered Pacific 0180, 0181, and 0187 through 0191.

in Los Angeles. On or about January 1, 1984, the Government began taking part of its royalties from the Santa Ynez unit in kind, and by November 1, 1984, all of the Government's royalty share was taken in kind and delivered by tanker to refineries in California. Once the change from royalty on value to royalty-in-kind occurred, there was a basis for calculating Exxon's transportation allowance using actual costs rather than hypothetical costs.

By decision dated March 21, 1986, RVSD directed Exxon to make the adjustment from hypothetical to actual transportation costs for the period from January 1, 1984, through April 30, 1985. The decision approved a transportation allowance of \$1.925784 per barrel. This decision was appealed to the Director, MMS, who affirmed RVSD. The Director's decision has been appealed to this Board.

The rate of return at issue is applied to the undepreciated portion of Exxon's capital investment in tanker ships utilized to transport production from the Santa Ynez unit. Attached to the RVSD decision is a document which contains the following statement pertaining to the rate of return utilized for calculation of the transportation allowance:

Return on undepreciated investment should be based on a[n] 11 percent rate of return representing the prime lending rate at the time of tanker retrofit. This is the rate established in the November 5, 1982, directive to Exxon which determined the transportation allowances for 1981 and 1982 based on hypothetical costs.

(Summary of Findings and Conclusions at 3).

In its statement of reasons (SOR) for appeal Exxon argues the rate of return is a cost-based allowance and, hence, "must closely approximate the cost of capital to the lessee which includes both the cost of equity and the cost of debt" (SOR at 4). Appellant contends that its costs are greater than the rate at which it can borrow and that no company can afford to invest money at a before-tax rate equal to its borrowing rate. Id. Exxon asserts that the rate of return allowed by MMS compares unfavorably to the rate of return for United States Treasury Bonds and various other financial instruments.

Appellant argues MMS' use of the prime interest rate in calculating the transportation allowance is arbitrary and irrational. Exxon maintains the Conservation Division Manual (CDM), 2/ upon which MMS bases its utilization of the prime interest rate, was developed for use with onshore, rather than offshore leases; the record does not support applying the prime

2/ Functions formerly handled by the Conservation Division, Geological Survey, were transferred to MMS effective June 30, 1982. 47 FR 28368 (June 30, 1982). The portions of the CDM at issue herein have subsequently been replaced by 30 CFR Part 206, Subpart C. 53 FR 1218-22 (Jan. 15, 1988).

or relate the prime interest rate to Exxon's actual costs of capital; and, further, that administrative convenience is not an adequate justification for using the prime interest rate as a rate of return. Appellant asserts that in the event we affirm MMS' use of the prime interest rate, it is more appropriate to utilize a weighted average of the prime interest rates in effect over the period of the capital investment, rather than to utilize the prime interest rate in effect on the day work began, and we should allow the prime interest rate as a rate of return on an after-tax, rather than before-tax, basis.

MMS contends the prime interest rate is a reasonable indication of the overall return on capital, and given the vast number of transportation allowances for which MMS must determine the rate of return, basing the rate on an operator's individual capital costs is impractical. MMS maintains the risks borne in transportation of production are less than appellant suggests, and disputes the validity of appellant's comparisons to other rates. In its answer, MMS admits the CDM was designed for onshore pipeline application, but states that the difference was taken into account by MMS. ^{3/}

In its answer, MMS provides the following explanation of how the rate of return was chosen:

[The March 21, 1986,] order continued the use of a[n] 11 per-cent rate of return on the undepreciated part of Exxon's investment in the tankers. The 11 percent rate of return was based on the prime lending rate at the time expenditures were actually incurred for the project. In this case, that time was August 19, 1980, the day the first tanker, the Exxon Lexington, arrived at the Newport News Shipyard for retrofitting.

(Answer at 2).

[1] The question of the rate of return to be allowed as an element of transportation costs was analyzed in Mobil Producing Texas & New Mexico, Inc., 115 IBLA 164 (1990). In that case we noted that:

In those situations where there is no market for production at the wellhead or in the field where production is obtained, the net-back or net-realization method of valuation for royalty purposes has been used to compute value at the point of production. Allow-ance of a return on capital investment has been recognized as an

^{3/} MMS asserts it was standard practice with respect to offshore oil and gas leases to allow an 8-percent rate of return in calculating a transportation allowance for offshore producer-owned transportation facilities. See Conoco, Inc., 109 IBLA 89 (1989). MMS notes that it declined to apply this rate to appellant (Answer at 14-15; Decision at 11). Rather, appellant's allowance was calculated using the higher rate of return based on the prime rate.

element of costs to be considered in using this methodology. United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal.), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950). In United States v. General Petroleum Corp., supra, the Department had allowed depreciation on capital investment in addition to the actual cost of operating the gathering system, but had refused to allow any return on capital investment, asserting that it was not allowable under the net-realization analysis. The court held that a "return on the lessees' depreciated investment in the wet-gas gathering system at Kettleman Hills should have been allowed." 73 F. Supp. at 257. The court found that the rate of interest prevailing in the community for sums of this size at the time in question was approximately 4 percent and that interest at that rate established "just compensation." 73 F. Supp. at 264.

This Board has previously had occasion to examine the issue of the reasonableness of a rate of return on depreciated assets in computing an allowance for transportation costs. In Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981), a case involving a transportation allowance for offshore production, we found that "a fair rate of return depends greatly on the economic conditions and other circumstances of the case at the time involved." 52 IBLA at 26, 88 I.D. at 6. In that case we upheld an allowance based on a 6-percent rate of return. In Black Butte Coal Co., 111 IBLA 275 (1989), involving an allowance for transportation and processing of coal produced under a Federal lease, the Board affirmed a transportation allowance in which the deduction for return on undepreciated investment was based on the prime rate of interest. 13/ Although there may be other measures of interest rate prevailing in the community at the relevant time, 14/ the prime

13/ In Phillips Petroleum Co., 109 IBLA 4 (1989), the Board remanded a case involving a transportation allowance calculated on the prime interest rate in effect on Jan. 1, 1975, where the audit period at issue was from 1976 through 1982. In that case we specifically noted the fact that the prime rate chosen was in effect at a time other than the relevant time and found compelling the emphasis in Shell Oil Co., supra, on the economic conditions at the time involved. Phillips Petroleum Co., supra at 15. We find Phillips to be distinguishable on the basis that the prime interest rate at issue here was the rate in effect for the initial period of the transportation allowance.

14/ The new Federal gas valuation regulations at 43 CFR Subpart D, 53 FR 1272 (Jan. 15, 1988), provide with respect to transportation allowances that the "rate of return shall be the industrial rate associated with Standard and Poor's BBB rating. The rate of return shall be the monthly average rate as published in Standard and Poor's Bond Guide for the first month of the reporting period

rate of interest is clearly one reasonable measure of prevail-ing interest rates at the relevant time. Accordingly, we find no error has been established by appellant in use of the prime interest rate to compute return on undepreciated investment.

fn. 14 (continued)

for which the allowance is applicable and shall be effective during the reporting period." 30 CFR 206.157(b)(2)(v), 53 FR 1280.

115 IBLA at 175-76. We regard this precedent as controlling in the pres-ent case. We have previously rejected the argument that the rate of return must be equivalent to the lessee's actual cost of capital. Conoco, Inc., 109 IBLA at 94.

We find that MMS has not been consistent in its application of the prime interest rate to capital expenses. In the Mobil case the Board upheld application of the prime interest rate in effect on the first day of the deduction period for which the transportation allowance was approved. In this respect the Board modified the decision of the Director, MMS, which had applied the prime rate existing at the time of approval of the transportation allowance. ^{4/} Although the approach upheld by the Board provided a more rational basis than using the date of approval of the allowance which could occur at any time, use of this date may not provide a more rational basis in the present case. In these circumstances, we find it appropriate to remand the case to MMS to resolve the inconsistency as a threshold matter.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is set aside and the case is remanded.

C. Randall Grant, Jr.
Administrative Judge

I concur:

R. W. Mullen
Administrative Judge

^{4/} In briefing the Mobil case counsel for MMS represented to the Board that it has always been the policy and the practice of MMS to apply the "prime interest rate in effect on the first day of the first deduction period, which is defined as any 12-month period for which the allowance will be effective." 115 IBLA at 174.